

STATE OF MINNESOTA
OFFICE OF HEARING EXAMINERS

FOR THE DEPARTMENT OF COMMERCE - SECURITIES DIVISION

In the Matter of the Broker-Dealer's
License of Reuben-Alstead & Co., Inc.,
the Securities Agent's Licenses of
Ben B. Reuben; Jerry A. Alstead;
Harvey A. Feldman; Douglas C. Mangel;
and George R. Zenanko.

FINDINGS OF FACT,
CONCLUSIONS,
RECOMMENDATIONS
AND MEMORANDUM

The above-entitled matter came on for hearing before George A. Beck, duly appointed as Hearing Examiner in this matter on October 6, 1976, at 9:30 a.m. in the office of Hearing Examiners' Hearing Room, at Room 300, 1745 University Avenue, in the City of Saint Paul, County of Ramsey, State of Minnesota. Testimony was subsequently heard on October 12, 14, 15, 18, 19, 20, 21, 25, 26, 27 and November 2, 9, 10, 15, 16, 17, 18, 22, 24 and December 2 and 6 of 1976, and January 21, 1977. The record remained open for the filing of briefs until July 29, 1977.

Thomas R. Muck, Assistant Attorney General, 500 Metro Square Building, Saint Paul, Minnesota 55101, appeared representing the Securities Division. Andrew W. Danielson, Esq. of the firm of Larkin, Koffman, Daly & Lindgren, Ltd., 1500 Northwestern Financial Center, 7900 Xerxes Avenue South, Minneapolis, Minnesota 55431, appeared on behalf of Reuben-Alstead & Co., Inc. and Ben B. Reuben. Roger H. Frommelt, Esq. of the firm of Frommelt & Eide, 4430 IDS Center, Minneapolis, Minnesota 55402, appeared representing Douglas C. Mangel and George R. Zenanko. Patrick Delaney, Esq. of the firm of Delaney, Thompson & O'Rourke, 2208 IDS Center, Minneapolis, Minnesota 55402, appeared on behalf of Jerry A. Alstead. Harvey A. Feldman appeared pro se.

During the course of the hearing, a settlement was reached between the Securities Division and Respondents Jerry A. Alstead and Douglas C. Mangel.

Witnesses at the hearing included: Ralph P. Klein, Paul J.

Vogel, Thomas H. Garrett, III John W. Scanlan, Michael Weich,
Harvey A. Feldman, George R. Zenanko, Ben B. Reuben, Dennis
Dacey, Grace Pinz, Larry Pieri, Lloyd Elfrink, Sherrill Stempf,
Duane W. Fogel, Myron Pieri, Eugene Pfeifer, William F. Stute,
Ralph S. Palmer, Nick P. Moes, Irvin F. Schuett, Anthony Silverman,
Douglas C. Mangel, Curtis Connor, Darwin Sandau, Charles H. Hauck,
Jack Loula, Jerry A. Alstead, Kenneth F. Johannson, Richard D.
Husebo, Tom R. Keyes, George E. Kline, John J. Cox, Roger H.
Frommelt, Earl S. Sanford, Thomas J. Carey, Jr., James J.
Grierson, Frank J. Donaty, Jr., and Edward A. Leonard.

Based upon all the testimony, exhibits, and briefs herein,
the Hearing Examiner makes the following:

FINDINGS OF FACT

NORCO OIL CORPORATION

1. Norco Oil Corporation ("Norco") was first incorporated in the State of Minnesota, under another name, in 1964. Norco had no sales or income until 1966 when it became engaged in the sale and distribution of general merchandise at wholesale. In 1967, Norco became engaged in the franchise business as well. However, the franchise program and the wholesale business resulted in substantial losses, and both operations were terminated in January of 1969.

2. In January of 1969, Norco became engaged in the distribution of petroleum products at retail. Norco sold its petroleum products on a consignment basis to independent operators who leased service stations from Norco. Norco's products were marketed under the "North Star" label. In August of 1971, Norco acquired the assets and business of Pronghorn Petroleum Corporation, Ltd. ("Pronghorn"), a Canadian federal corporation. Pronghorn was engaged in the acquisition, exploration and development of oil and gas leases in Montana, Wyoming, North Dakota and Ohio; and also owned claims to jade deposits located in Wyoming. As of January 1, 1972, Pronghorn owned interests in 34 producing oil and gas wells.

3. Norco's oil and gas operations produced losses in each of

the years 1972 through 1974. There was no improvement in late 1974 or 1975. The oil and gas wells were plagued by problems such as low pressure, a high amount of salt water mixed with the oil, mechanical difficulties, and lawsuits. Norco described the production performance of the oil and gas fields as disappointing, with income less than anticipated, in its 1973 and 1974 Form 10K reports submitted to the Securities and Exchange Commission ("SEC").

4. Norco's Wyoming jade claims were estimated by management to be approximately three percent gemstone quality with the remainder commercial grade jade. The jade operations produced losses for the years 1972 through 1974. In 1973, Norco attempted to market its jade ore through a joint venture with Felco Jewel Industries, Inc. However, sales were negligible and the joint venture was terminated as of June 30, 1973. By September 30, 1974, Norco had mined approximately 400,000 pounds of jade ore, and employed approximately five employees in its Riverton, Wyoming plant. As of September 30, 1974, however, Norco had no knowledge of any established markets for products made from commercial jade, nor did Norco anticipate any significant jade jewelry sales. Norco never did develop a jade marketing or sales organization or sell any significant amount of jade products. In its annual report for the 1974 fiscal year, Norco valued its jade mineral property claims and equipment at \$539,305. Norco stated in its 1973 SEC 10K report that no meaningful dollar estimates could be given concerning the value of the jade claims since such estimates are dependent upon the successful mining, processing and marketing of the finished jade and the location of the gem quality jade. In Norco's bankruptcy proceedings, commenced in June of 1975, its jade claims were sold for \$66,000.

5. During 1974, Norco sold petroleum products through its retail oil station division to two independently operated service stations and to eight Norco-owned service stations. The oil station division by itself showed a net income before taxes of \$30,785 for the 1973 fiscal year, and a net income of \$94,000 for the fiscal year 1974. In its 1974 10K report to the SEC, Norco stated that its oil station division purchased gasoline and other

petroleum products from Northwestern Refining Company ("Northwestern"), a division of Ashland Oil Co., and that Norco was currently indebted to Northwestern for purchases past due in the amount of \$64,366. Norco had been behind in its payments to Northwestern for gasoline and station rent since approximately 1972. As of January, 1975, Norco owed Northwestern approximately \$250,000 which was past due. Norco had no other sources of supply of gasoline besides Northwestern, and Northwestern was cancelling its contracts with Norco as they came due because of Norco's default in payments. In the 1974 annual report, Norco's President stated that, "The division has been profitable, however costs of supplies and the extremely erratic nature of the petroleum business do not permit any degree of predictability for future profits."

6. Norco showed a loss on its total operations in each of the years 1970 through 1973. Norco's annual statement for 1973 showed a net loss of \$129,084, for a net loss per share of common stock of \$.03. The 1974 annual report for the fiscal year ending September 30, 1974 recorded net earnings of \$201,953. The following chart appeared on the inside cover of the 1974 annual report.

	FINANCIAL HIGHLIGHTS		
	1974	1973	1972
Total revenue.....	\$2,838,876	\$1,896,437	
\$2,224,239			
Net earnings (loss).....	201,953	(129,084)	
(432,985)			
Net earnings (loss)			
per common share.....	\$.05	\$(.03)	
\$(.10)			
Selling and administra-			
tive expenses.....	140,910	151,303	
301,394			
Working capital provided			
from (used in) opera-			
tions.....	\$ 322,113	\$ (398)	\$
(124,270)			

The 1974 annual report also reveals, however, that of the \$245,553 earnings recorded before income taxes, \$235,225 represented a gain on the non-recurring sale of certain North Dakota oil properties which were sold in August of 1974. The profit from operations amounted to \$10,328. This profit was from the retail oil station division. Total assets for fiscal 1974 amounted to \$1,363,138, which included the jade claims carried at a value of \$505,726, and

the jade production costs which were capitalized in the amount of \$227,415. The total current assets were listed at \$375,486, as against total current liabilities of \$811,919.

7. Both the 1973 and the 1974 annual reports contained auditors' reports which were not "standard opinions", but which in fact disclaimed any opinion since the accountants were not able to assume a "going concern" in regard to Norco. This type of disclaimer is rare and is intended to put the reader on notice that a company is in a precarious financial position. The accountants' disclaimer of opinion was due primarily to the large accumulated deficit, the failure of the divisions to show a profit, the presence of lawsuits, the fact that current liabilities exceeded current assets, the fact that a major supplier had an unpaid balance, and the fact that Norco had capitalized the jade processing costs, but had no sales as yet.

8. Norco maintained several bank loans to finance its operations. The 1973 annual report stated that Norco was in default on its monthly payments of principal towards a \$250,000 bank loan so that the bank had the option of declaring the loan currently due and payable. Norco Director Irwin Jacobs had personally guaranteed this bank loan. On September 30, 1973, Norco's total bank debt was \$432,751. In its 1974 annual report, Norco stated that on July 23, 1974, the bank had demanded payment of the \$370,000 indebtedness in full. In October, 1974, Norco paid approximately \$210,000 to the bank from the proceeds of the sale of the North Dakota oil properties which left approximately \$160,000 due and payable. one director described Norco's financial condition as "always precarious".

9. In a Form 10Q filed with the SEC on February 18, 1975, Norco reported a net loss of \$43,524 for the last three months of 1974. Norco's Form 10Q filed with the SEC on May 15, 1975, reported a net loss of \$92,140 for the six months ending March 31, 1975. On April 30, 1975, Northwestern, Norco's only supplier of petroleum products, notified Norco that it would cease making deliveries of gasoline and other petroleum products unless payment for such deliveries were tendered at the delivery site in cash. Since

Norco was unable to meet this demand, it had to close its seven company operated stations after running out of gasoline. As of May 1, 1975, Norco owed Northwestern approximately \$67,108 which was past due on a trade note and approximately \$160,000 for petroleum products purchased but not paid for and approximately \$4,750 in back rent on four service stations leased from Northwestern. In a Form 8K report filed with the SEC on May 13, 1975, Norco reported that it was negotiating with Northwestern to resume deliveries of gasoline, but that no assurances could be given that Northwestern would extend further credit and, accordingly, Norco was reviewing various debtor remedies available to it, including a petition under Chapter 11 of the Federal Bankruptcy Act.

10. On May 15, 1975, Northwestern commenced a lawsuit against Norco for overdue accounts and on May 27, 1975, replevin papers were served upon Norco by Northwestern concerning Norco's service station properties. As a result of these events, the President of Norco contacted its Board of Directors on May 28 and 29, and a Board of Directors' meeting was set for May 30, 1975, which was attended by all directors except Mr. Finkelstein. The Board voted at that meeting to ask the State of Minnesota to suspend the trading of its stock and to file for a Chapter 11 bankruptcy. The Commissioner of Securities issued an order suspending the trading of Norco stock on May 30, 1975. Norco made no public announcement concerning its difficulties prior to May 30, 1975, aside from its SEC filings. Norco filed in bankruptcy court on June 5, 1975, and was adjudged an ordinary bankrupt in late August of 1975.

11. In May of 1975, Ralph P. Klein was President of Norco, Hy Finkelstein was Vice President, and Irwin Jacobs was Secretary-Treasurer. Irwin Jacobs is an influential Minneapolis businessman with an interest in several corporations. In the spring of 1975, he and some associates purchased Grain Belt Breweries in Minneapolis. Jacobs was an "active" director of Norco in the sense that he often took a hand in trying to solve Norco's problems. The Board of Directors consisted of the three officers plus Robert Haag, Tibor Zoltai and George Kline. Ralph Klein was the only person employed

full-time in management for Norco. He became President in December of 1972. There was no change in the Board of Directors or among the officers from 1973 to the filing for bankruptcy, nor was any merger between Norco and any other corporation contemplated. Although Norco filed with the SEC, its securities were not registered under the Securities Act of 1933.

REUBEN AND THE KLINE TRANSACTION

12. Ben B. Reuben ("Reuben") was, at all times relevant herein, and is currently licensed as a securities agent by the State of Minnesota. Reuben has held a securities license since 1970. In March of 1973, Reuben founded Reuben-Alstead and Co., Inc. ("Reuben-Alstead"). Reuben is the President, a majority stockholder, a director and a financial principal of Reuben-Alstead. Reuben-Alstead is licensed as a corporate securities broker. Reuben is ultimately responsible as President for all areas of operation within the firm. Reuben directly supervised the securities agents with the help of his sales manager. The firm grew from four securities agents at its inception to approximately 40 full and part-time agents in April of 1975.

13. George E. Kline ("Kline") was a director of Norco from 1967 through Norco's bankruptcy in August of 1975. In late March of 1975, Kline met with Reuben over lunch. Kline told Reuben that he wanted to sell the 35,000 shares of Norco stock which he owned and asked Reuben if the market would support the sale of that many shares. Kline had obtained the shares in 1969, and 1971. He had decided to sell in early 1975 due to a need for cash, but he decided to wait until after the issuance of the 1974 annual report in February of 1975. Reuben told Kline that he could move the shares into the market since some of his brokers were interested in the stock. They agreed that Kline would receive \$.25 per share. Since Kline was a director of Norco, the 35,000 shares in question bore a restrictive legend which would have to be removed before the stock could be sold. Reuben had previously sold restricted stock for Kline, and Reuben knew that Kline was a director of Norco. Kline told Reuben that he would proceed to get the legend

removed from the Norco stock and would then deliver the shares to Reuben. Reuben asked Kline no "Rule 144" questions at the luncheon meeting, nor did Reuben tell Kline that his compliance officer would have to examine the transaction.

14. Generally, SEC Rule 144 provides that a controlling person may dispose of unregistered legended stock if the stock is sold in an agency rather than a principal transaction and if no purchasers are solicited for the stock.

15. Shortly thereafter, Kline proceeded to the office of Norco's corporate counsel and advised them that he wanted to sell his 35,000 shares of Norco on a "Rule 144" basis and that he needed the restrictive legend removed from the stock. The corporate counsel advised Kline that before they could write a letter to the transfer agent requesting that the legend be removed, they would have to have, among other things, a letter from Reuben-Alstead acknowledging that the sales were executed pursuant to the provisions of Rule 144.

16. Kline then immediately proceeded to the offices of Reuben-Alstead and asked to see Reuben. Since Reuben was out of the office, Kline talked to Jerry A. Alstead ("Alstead"). Alstead was Executive Vice President of Reuben-Alstead and also a director and shareholder. He organized the firm with Reuben in 1973. The compliance officer, Richard D. Husebo ("Husebo") was not present at the office when Kline arrived.

17. Kline told Alstead that Reuben was aware of this transaction, showed Alstead a "144 form" and the restricted Norco stock, and requested the letter required by counsel for Norco. Alstead agreed to sign a letter and suggested to Kline that the stock be put in the "Kevco" name, which is Reuben-Alstead's street name. Kline then proceeded to dictate a letter to Alstead's secretary which Alstead then reviewed and signed. The letter, which was dated April 8, 1975, read as follows:

George E. Kline has sold 35,000 Shares of Norco Oil Corporation common stock pursuant to Rule 144 of the Securities and Exchange Commission. We are in receipt of Form 144 which Mr. Kline has provided us; he has also informed us that he has mailed three copies of the form to the Commission. Sales

have been executed with our clients pursuant to the provisions of Rule 144.

Please issue to our firm these shares:

Name of Kevco
Denomination: 3 x 10,000
1 x 5,000

18. The letter is signed by Jerry A. Alstead as Executive vice President of Reuben-Alstead & Co., Inc. Kline then took the letter back to the office of Norco's law firm. Alstead did not ask Kline any questions about the transaction and did not mention it to Husebo. Alstead took no steps to prevent Kline's shares from reaching Reuben-Alstead's trading inventory or from being sold on a solicited basis.

19. Upon receipt of the letter from Alstead, Norco's counsel drafted a letter to the transfer agent allowing removal of the restrictive legend on Kline's stock. This letter, together with Kline's certificates, were then delivered to the transfer agent. Based upon the opinion letter from Norco's counsel, the transfer agent removed the restrictive legends from the stock and then transferred Kline's stock to "Kevco". The share certificates in Kevco's name were dated April 10, 1975. When the Norco shares in the "Kevco" name were delivered to Reuben-Alstead, Husebo asked Reuben whether the shares were free and clear to trade and Reuben advised Husebo that he had checked the facts surrounding the trade and that the shares were tradeable.

20. Reuben was able to sell 10,000 of the shares for Kline on April 1, 1975, at \$.22 per share. The proceeds from the sale were transmitted to Kline by a check dated April 10, 1975, and signed by Husebo. During the months of April and May, 1975, Kline continued to call Reuben inquiring as to when the remainder

of the shares would be sold. The remaining 25,000 shares were not sold for Kline until May 28, 1975, at 6:40 p.m. at \$.10 per share. The agent on both sales was Reuben. The 35,000 shares of Norco which Reuben-Alstead purchased on a principal basis were placed in Reuben-Alstead's trading inventory and at least 10,000 of the shares were then sold by Reuben-Alstead's agents to clients who were solicited to buy the stock. Reuben did not instruct any

of the firm's agents not to solicit purchasers for the stock purchased from Kline.

SILVERMAN

21. Anthony Silverman ("Silverman") was licensed as a securities agent to Reuben-Alstead from November of 1974 to September of 1975. Shortly after Silverman joined Reuben-Alstead, he asked Reuben if the firm would make a market in Norco stock, since Silverman was interested in the stock and had bought a good deal of the stock for his clients in the past. Reuben decided to make a market in Norco. Reuben-Alstead conducted no research on Norco aside from obtaining the annual reports. Silverman kept his own personal file with information concerning Norco at the Reuben-Alstead office in addition to Reuben-Alstead's trading file although no one at Reuben-Alstead told him to do so. Reuben did not ask Silverman to research Norco. Silverman's file contained the annual reports for 1972, 1973 and 1974, together with a six-month report for the period ending March 31, 1974. Silverman's file also contained some newspaper clippings concerning Norco's jade claims. Silverman was considered the resident "expert" on Norco stock since he knew Sheldon Jacobs, who was the brother of director Irwin Jacobs. Silverman talked to Sheldon Jacobs approximately two times a week about Norco. Silverman also occasionally talked to Norco's President, Ralph Klein. In the spring of 1975, Silverman's customers held in excess of 100,000 shares of Norco. Silverman bought 2,000 shares for his customers in March, April and May of 1975.

22. The larger Twin Cities brokerage firms and the national brokerage firms with Twin Cities offices maintain research departments which develop a recommended list of stocks. Generally, the research department will look at the quarterly and annual reports from a company, the minutes of shareholder meetings, the company's SEC filings, and will conduct periodic interviews with management before making a recommendation. Many companies mail their SEC filings directly to the brokerage firms interested in their stock. Securities agents with larger firms are required to buy stocks for their clients from the recommended list with certain exceptions. Some firms require that a non-recommended

stock must have a certain net income figure, such as \$10 million net income in two of the past three years, before an agent will be allowed to buy it for his clients. Other firms require that an agent must justify to management buying a stock which is not on the research department recommended list. Some firms prohibit their agents from selling any stock which is priced under \$3.00, based upon the belief that such a stock is highly speculative, highly volatile and may be of questionable merit. It is generally agreed that while there is usually less information available on a speculative company, there is a greater need for current information, including frequent personal contacts. Most firms do not require the agents themselves to review SEC filings. If an SEC filing is requested from the SEC, there could be a delay of approximately two to three weeks before it is received unless expedited service is requested. Silverman testified that had he reviewed Norco's SEC filing for the first five months of 1975, he would not have recommended Norco to his clients.

23. Although Reuben was unaware of any specific negative information about Norco prior to May 28, 1975, (such as Northwestern stopping delivery of gasoline or the commencement of lawsuits) he was concerned about the large amount of Norco that was available in the market. Reuben thought Norco was a very risky investment during March through May of 1975, and was aware that his agents were soliciting orders for Norco during this period. Reuben-Alstead sold over 100,000 shares of Norco in March, April and May of 1975.

24. On May 27, 1975, in the afternoon, Sheldon Jacobs called Silverman and told him not to buy any more Norco because something was wrong at Norco. Sheldon Jacobs gave no specifics beyond this explanation even though he was pressed for details by Silverman. On May 28, 1975, between 8:30 a.m. and 9:00 a.m., Silverman talked to Reuben in the Reuben-Alstead trading room. Silverman told Reuben before the market opened that there might be a possible problem with Norco and that Silverman's source had told him not to buy Norco any more. Reuben told Silverman that he had also heard that there might be some problem with Norco. Silverman requested Reuben's permission to sell through another firm the

10,000 shares of Norco in Reuben-Alstead's inventory which Silverman had "taken down" or agreed to be responsible for. Reuben gave Silverman permission to put the 10,000 shares in Silverman's account and to sell them and Reuben also asked Silverman to sell 15,000 or 25,000 shares for Reuben if he could. Silverman was able to sell 10,000 shares on May 28, 1975, but was unable to sell any for Reuben since the market would not support the sale. Silverman did not tell any of his customers to sell or advise the other brokers in Reuben-Alstead about the message he had received.

25. Dennis Dacey ("Dacey") was employed by Reuben-Alstead from July of 1974 to July of 1976. Dacey acted as a sales manager and was active in the hiring and training of new securities agents. With Reuben's approval, Dacey organized a sales contest to take place on May 29, 1975. Those agents who sold a certain amount of securities on that date received gift certificates at a local clothing store. Any security was eligible for the contest. Prior to the contest, Dacey asked Reuben for a list of the stocks he was holding in inventory and Reuben provided the list. On May 29, 1975, Dacey announced the sales contest over a loudspeaker at Reuben-Alstead, and he also announced the names of the stocks which Reuben-Alstead was holding in inventory, including Norco. Feldman did not participate in the sales contest; however, Zenanko and Mangel both participated in the contest and both sold Norco stock during the contest. Zenanko won a gift certificate as a result of the contest and sold approximately 7,000 to 8,000 shares of Norco. Reuben-Alstead's agents sold over 37,000 shares of Norco on May 29, 1975.

COMPLIANCE

26. Richard D. Husebo was employed by Reuben in May of 1974 as a compliance officer and as an officer in charge of operations. Husebo was also a financial principal of the firm. Husebo spent approximately one-half of his time on accounting, approximately one-fourth to one-third of his time with operations, and the balance of the time dealing with compliance matters. Husebo was supposed to hold compliance meetings immediately following the bi-weekly sales meetings of the firm. However, Husebo frequently

failed to hold the meetings and, on at least one occasion, this was the subject of a written memorandum from Reuben to Husebo in April or May of 1975. When compliance meetings were held, they comprised approximately 10 to 15 minutes of the one hour sales meeting. Zenanko testified that there were only two compliance meetings held while he was with Reuben-Alstead, which was from February of 1975 to September of 1975. All of the firm's agents were expected to attend the sales meetings and a majority of the agents did attend. Topics which were discussed at compliance meetings at some time during Husebo's tenure with the firm included the requirements of Rule 144, guarantee of a stock's performance, promising a specific price increase, suitability of a stock for a client, and the necessity of a reasonable basis for recommending a stock. Reuben was not satisfied with Husebo's performance while he was with the firm in that Husebo often failed to accomplish tasks and was absent from the office for lengthy periods. Husebo remained with the firm however until April or May of 1976, at which time Reuben requested his resignation.

27. Reuben-Alstead maintained a policy and procedures manual which was available to all agents. The manual contained a memorandum dated July 23, 1973, a portion of which read as follows:

Some practices that have resulted in disciplinary action and expulsion that we are all familiar with are as follows: recommending speculative low price securities. The-theory here is that this practice involves a high probability that these kinds of securities will not be suitable for some of the persons solicited.

The manual also contained brief statements concerning suitability and reasonable basis for recommendation and guaranteeing price

increases. A memorandum concerning the sale of Rule 144 stock was also included in the manual, together with a checklist to be followed when making such a sale. The firm usually executed eight or nine sales pursuant to Rule 144 each month. The compliance officer was assigned the duty of issuing the "Rule 144" letter on behalf of the firm.

28. All agents were required to classify their new customers,

based on their investment objectives, on the new account form. The form lacked space for any information about the client's financial situation or current portfolio. The trading room, where Reuben spent approximately 75 percent of his time during the first half of 1975, was supposed to check the stated investment objective against the customer's first order. The compliance officer was then to review the transaction to check its propriety. Reuben personally reviewed the order tickets and confirmation slips and application forms each day for the firm to assure they were in order. Reuben-Alstead kept a trading or a "due diligence" file for each stock it made a market in. The firm would usually get annual reports and financial statements from its market making companies by asking the company to send all shareholder notices. Reuben-Alstead received Norco's 1974 annual report on approximately February 21, 1975. Reuben was responsible for spot checking the trading files to ensure their completeness approximately every three months.

FELDMAN

29. That Harvey A. Feldman ("Feldman") was, at all times relevant herein, and is currently licensed as a securities agent by the State of Minnesota. Feldman was licensed to Reuben-Alstead from approximately December of 1974 to September of 1975. This was Feldman's first employment in the securities industry. Feldman attended a three-day securities course in November of 1974, prior to taking the securities licensing examination. The course included compliance subjects and is geared to help the student pass the licensing examination. He received no further formal training while employed at Reuben-Alstead. Feldman did not receive a copy of the Reuben-Alstead policy manual, nor was he ever given any guidelines or instructions concerning solicitation of customers or recommendation of stock.

30. In March and April of 1975, Feldman recommended the purchase of Norco Oil Corporation stock to several of his customers. Seven of his customers purchased Norco stock and, with the exception of one customer, each of the sales were solicited. Prior to making

the Norco recommendation, Feldman had reviewed the 1974 Norco annual report and two earlier newspaper clippings concerning Norco which were contained in the Reuben-Alstead trading file. Feldman never saw any of Norco's SEC filings. Feldman testified that he recommended the stock because Norco was in the energy business, had some jade prospects, had an upward net earnings trend and was trading at a very low price. Feldman was aware that the company's 1974 earnings were primarily due to a sale of assets. He was not aware that Norco was having any retail gasoline supply problems in 1975.

31. Feldman called Grace Pinz ("Pinz") of Isle, Minnesota, three times in March of 1975 to recommend to her the purchase of Norco stock. Mrs. Pinz is a housewife and a bookkeeper for her husband's sand and gravel business. Feldman told her that Norco was in the gasoline business and also owned a jade mine which was promising for development. He also mentioned that Irwin Jacobs, whose name has recently been in the newspaper in connection with the purchase of Grain Belt Breweries, also had an interest in Norco. During the third phone call on approximately April 9, 1975, Mrs. Pinz agreed to purchase 1,000 shares of Norco at \$.40 per share. She told Feldman that this was the first stock purchase which she and her husband had made and that they were relying on his judgment. Feldman did not disclose the source of his information about Norco to Mrs. Pinz, nor did he mention anything negative about Norco.

32. Feldman called Lloyd Elfrink ("Elfrink") twice in April of 1975 to recommend and solicit his purchase of Norco stock. Mr. Elfrink is a service station mechanic who resides in Belgrade, Minnesota. Feldman told Elfrink that Norco owned the North Star service stations, that they possessed jade claims, and that since Norco was in an energy business, they should benefit from the energy crisis. Feldman also said that Norco could double in price. On April 17, 1975, Elfrink purchased 500 shares of Norco at \$.35 per share.

33. Feldman also telephoned Sherril Stempl ("Stempl") of Onamia, Minnesota, in April of 1975. Mr. Stempl operates a garage

and salvage yard. Feldman told Stempl that Norco owned the North Star gasoline stations and that a man involved in Norco was buying the Grain Belt Breweries. Feldman also told Stempl that he believed that Norco would double in value in about two years. On May 6, 1975, Stempl bought 500 shares of Norco at \$.40 per share.

34. Feldman also called Duane Fogel ("Fogel"), a chiropractor who resides in Milaca, Minnesota. Feldman told Fogel that Norco owned the North Star gasoline stations which would do well in an oil crisis and that the jade division had a large deposit of jade. Feldman also mentioned that Irwin Jacobs, who was buying Grain Belt Breweries, was involved with Norco. Fogel purchased 1,000 shares of Norco at \$.40 per share on April 4, 1975. This was his first securities investment.

35. Feldman called Myron Pieri, a produce manager who resides in Anoka, Minnesota, in early April of 1975. Feldman recommended the purchase of Norco stock to Pieri and suggested that it was a good buy since there was a possibility of a merger between Norco and another company. After the initial telephone conversation, Myron Pieri called Feldman on April 9, 1975, and bought 500 shares of Norco at \$.40 per share.

36. Feldman also talked in mid-April of 1975 to Larry Pieri after Feldman talked to his brother, Myron Pieri. Larry Pieri is currently a bank operations officer in Sioux City, Iowa. Feldman told Larry Pieri there was a possibility of Norco merging with Grain Belt Breweries and that the price of Norco would go up due to this. Larry Pieri bought 500 shares of Norco at \$.40 per share on April 9, 1975.

37. Eugene Pfeifer ("Pfeifer") owns a small janitorial service company in Minneapolis. Feldman called him three times in April of 1975, to recommend and solicit his purchase of Norco stock. Feldman told Pfeifer that Norco ran the North Star gasoline stations and that Norco had its own oil operations. Feldman also mentioned that Norco had experienced a profit in the previous year and owned a jade mine. On April 4, 1975, Pfeifer bought 1,000 shares of Norco at \$.40 per share. This was the first time that

Pfeifer had ever purchased a security.

38. In the course of his recommendations to the above-mentioned customers, Feldman did not mention the following: That Norco was in default on a loan with the Northwestern National Bank and that \$160,000 still remained due on the note; that Norco was in default on a trade note to its gasoline supplier; that Norco's 1974 annual report revealed that the company's current liabilities exceeded its current assets by over \$400,000; that Norco had lost money in each of the years 1967 to 1973; that all but \$10,000 of the 1974 profit of the company resulted from a sale of certain assets; that Norco lost \$43,000 for the quarter ending December 31, 1974, a loss which was \$40,000 greater than for the same quarter of the previous year; that Norco lost \$92,000 for the six months ending March 31, 1975; that Norco in its SEC filings called production of its oil and gasoline wells disappointing; that Norco had no knowledge of any established markets for the products of its jade operations; that Norco had stated in its SEC filings that it could give no meaningful dollar estimate to the value of its jade claims; that Norco did not anticipate any significant jade jewelry sales; or that Norco's accountants in both 1973 and 1974, had expressed doubts about the company's ability to continue as a going concern.

ZENANKO

39. George Zenanko ("Zenanko") was, at all times relevant herein, and is currently licensed as a securities agent. He has been licensed since 1972, and was associated with Reuben-Alstead from February of 1975 to September of 1975. During the month of May, 1975, Zenanko solicited and recommended the purchase of Norco stock to several of his customers. Zenanko's recommendation was based upon the 1974 annual report of Norco and the earlier newspaper clippings concerning Norco which were in the Reuben-Alstead trading file. Zenanko reviewed the 1974 annual report for approximately 20 minutes in March of 1975. He at no time reviewed any of Norco's SEC filings and in fact was unaware that Norco filed with the SEC. Zenanko was unaware that Norco's gasoline supply had been cut off on April 30, 1975. No one at Reuben-Alstead advised him prior to May 30, 1975, that Norco was in any trouble.

40. Zenanko received no formal training at Reuben-Alstead. Specifically, he was never given any guidelines as to what facts to gather before recommending a stock, nor was he advised to review SEC filings, nor was he told to review the trading file for a stock prior to recommendation, nor was he advised to get the most recent information before recommending a stock. Zenanko was not advised by anyone at Reuben-Alstead that he should inquire about the financial position or investment portfolio of clients or that he should refrain from predicting dollar increases in stock. No one at any time at Reuben-Alstead ever advised him not to solicit purchasers for any Norco stock held in inventory. Zenanko did participate in a six-month training course with a national securities firm when he first became a securities agent in 1972.

41. That on May 20, 1975, Zenanko called Ralph S. Palmer ("Palmer") a law student who resides in St. Paul, Minnesota. Zenanko had called to talk to Palmer's father who was out of town. However, when Palmer expressed an interest, Zenanko proceeded to tell him about Norco stock. Zenanko mentioned the existence of jade deposits, and the fact that Norco had achieved \$.05 per share earnings in 1974, and Zenanko told Palmer that Irwin Jacobs had put a large sum of money into Norco. Zenanko told Palmer that Norco was a good buy. Zenanko did inquire about Palmer's job and current stock holdings. Palmer bought 1,000 shares of Norco on May 20, 1975, at \$.40 per share.

42. William F. Stute ("Stute") is an aircraft fuel serviceman who resides in Cottage Grove, Minnesota. He has been a customer of Zenanko's since 1973. Zenanko asked Stute about his financial situation and his investments in 1973 when he first became Zenanko's customer. Zenanko called Stute on May 29, 1975, to recommend the purchase of Norco. Zenanko mentioned to Stute the existence of jade claims and told Stute that although Norco had not done real well in the past, the management was sound and there was a good potential, especially since the earnings trend was upward. Stute bought 2,000 shares of Norco on May 29, 1975, at \$.40 per share.

43. On May 29, 1975, Zenanko also called Ervin P. Schuett

("Schuett") a Western Airlines fleet service employee who resides in South St. Paul, Minnesota. Schuett had been a customer of Zenanko's since 1973 and had previously purchased speculative stock from Zenanko. Zenanko told Schuett that Norco possessed oil leases in North Dakota, gas leases in Ohio, and jade mines in Wyoming. Zenanko also mentioned that Irwin Jacobs, a Norco director, was buying Grain Belt Breweries. Schuett also recalls Zenanko telling him that Norco was in the process of selling some of its service stations, but does not recall any negative factors being mentioned. Schuett purchased 1,000 shares of Norco from Zenanko on May 29, 1975, at \$.40 per share.

44. Zenanko called Nick P. Moes ("Moes") on May 29, 1975. Moes is a supervisor of chemical technicians for Minnesota Mining and Manufacturing and resides in Hastings, Minnesota. Zenanko told Moes that Norco possessed oil wells, jade mines, and that Irwin Jacobs was instrumental in operating the company. Zenanko also told Moes that he believed that Norco could double in eight months to a year. Moes had previously purchased speculative stock from Zenanko. Moes bought 1,000 shares of Norco on May 29, 1975, at \$.40 per share.

45. Zenanko also telephoned Kenneth F. Johannson ("Johannson") on May 29, 1975. Johannson is an attorney who resides in Crookston, Minnesota. Johannson had been a customer of Zenanko's since 1973, and had purchased a good deal of speculative stock. Zenanko mentioned to Johannson that Norco possessed jade claims, that Norco had a cash shortage problem, but Zenanko said that it was more likely that Norco would increase than decrease in price. Based upon their telephone conversation, Johannson purchased 2,000 shares of Norco on May 29, 1975, at \$.40 per share.

46. Zenanko, in making recommendations to his clients concerning Norco stock, did not tell his customers the following: That Norco was in default on a bank loan; that Norco was in default on a trade note to its gasoline supplier; that in its 1974 annual report Norco's current liabilities exceeded its current assets; that Norco lost money in each of the years 1967 through 1973; that except for \$10,000, the 1974 profit resulted from a sale of assets; that

Norco experienced a \$43,000 loss for the quarter ending December 31, 1974; that Norco had a \$92,000 loss for the six months ending March 31, 1975; that in its SEC filings, Norco described its oil and gas well production as disappointing; that Norco had experienced problems with its oil and gas wells; that Norco had no established jade market or meaningful dollar estimates of the value of its jade claims or that Norco had no significant jade jewelry sales; or that Norco's accountants were unable to express an opinion concerning Norco in its 1973 and 1974 annual reports since they were unable to assume that Norco was "a going concern". Zenanko did not advise his Norco clients what information he was relying upon in making his recommendation or that he lacked current or complete information about Norco.

47. Zenanko was aware that the oil and gas operations had been described as disappointing and that the wells had salt water problems. Zenanko was also aware that most of the 1974 earnings were due to a sale of assets in North Dakota. Zenanko did not learn that Norco's retail gasoline supply had been cut off until after May 29, 1975.

48. When Zenanko learned of Norco's bankruptcy filing shortly after May 29, 1975, he called each of the clients to whom he had sold Norco stock on that date and advised them to stop payment on the check used to pay for the Norco stock. One of the clients was able to act in time to stop payment of his check. Zenanko also sent copies of a newspaper article describing the Norco's bankruptcy to each of his clients who had purchased Norco stock. Zenanko subsequently left Reuben-Alstead due to the Norco experience.

MANGEL

49. That Douglas C. Mangel ("Mangel") was, at all times relevant herein, licensed as a securities agent by the State of Minnesota. He attended the three-day securities course in January of 1972, before becoming licensed. Mangel was licensed to Reuben-Alstead from February of 1975 to November of 1975. Mangel recommended the purchase of Norco to several of his customers and solicited their purchase over the telephone in April and May of 1975.

50. Mangel made two telephone calls to Darwin Sandau ("Sandau") in March and April of 1975. Sandau is employed as a hostler helper for Burlington Northern Railroad in Minneapolis. Mangel told Sandau that Irwin Jacobs was involved with Norco and that a Japanese firm was going to make a go of Norco's jade business. Mangel advised Sandau that he could double his money in a few months and purchase a new truck. On April 2, 1975, Sandau bought 1,000 shares of Norco at \$.40 per share.

51. On May 29, 1975, Mangel called Charles Hauck ("Hauck") a farmer who resides near Madison, Minnesota. Mangel mentioned that Norco had jade mines. Hauck had purchased a speculative stock from Mangel in April of 1975, which was his first stock purchase. At the time of this April purchase, Mangel asked Hauck if he owned any stock, but Mangel did not inquire about Hauck's financial situation. On May 29, 1975, Hauck purchased 2,000 shares of Norco at \$.40 per share.

52. Mangel also called Jack Loula ("Loula") on May 29, 1975. Loula is a supermarket owner in Ortonville, Minnesota, who had previously purchased stock from Mangel. Mangel told Loula that Norco owned a jade mine and that Irwin Jacobs was involved with the company. Loula purchased 2,000 shares of Norco on May 29, 1975, at \$.40 per share.

53. Mangel called Curtis Connor ("Connor"), a farmer from Madison, Minnesota, on May 29, 1975, to solicit his purchase of Norco stock. Mangel advised Connor that Norco had new management and that its business was going to turn up. Connor had purchased a speculative stock from Mangel in April of 1975, at which time he told Mangel that it was his first stock purchase. Mangel did not ask Connor for any financial information. Connor bought 2,000 shares of Norco on May 29, 1975, at \$.40 per share.

54. In recommending the purchase of Norco to his clients, Mangel failed to mention the following: That Norco was in default on its bank loans; that Norco was in default on a note to its gasoline supplier; that the 1974 annual report showed that current liabilities were greater than current assets by over \$400,000; that Norco lost money in each of the years 1967 through 1973; that

the 1974 profit resulted from a sale of assets, except for \$10,000; that Norco lost \$43,000 for the quarter ending December 31, 1974; that Norco lost \$92,000 for the six months ending March 31, 1975; that Norco had described its oil and gas well production as disappointing in SEC filings; that Norco had no knowledge of any established markets for the products of its jade operations; that Norco could give no meaningful dollar estimate to the value of its jade claims; that Norco did not anticipate significant jade jewelry sales; that in its 1973 and 1974 annual reports, Norco's accountants refused to express an opinion because they were not able to assume that Norco would continue as a "going concern". Mangel did not advise his clients that he lacked current or complete information about Norco. Mangel reviewed the 1973 and 1974 annual reports.

INVESTIGATION

55. The investigation leading to the issuance of an order for Hearing in this matter was a joint investigation connected by the Securities Division with the National Association of Securities Dealers ("NASD"). John J. Cox ("Cox") who was supervisor of the anti-fraud section for the NASD, visited Minneapolis in August of 1975 to conduct an examination at several brokerage houses. The referral from the NASD Chicago office which sent Cox to Minneapolis did not mention the Norco stock activities. Subsequent to his arrival in Minneapolis, Cox received a letter from the Chicago office mentioning the possibility of an irregular "Rule 144" transaction concerning Norco.

56. Cox advised Reuben that he was looking at a "Rule 144" transaction, and asked Reuben for order tickets, confirmation slips and the trading file. Reuben agreed to provide and did provide these items. Cox requested and was voluntarily provided what subsequently became Exhibits 18 through 21, 22, 23, 27 and 32 through 211, from Reuben-Alstead. Each of these exhibits are items which Reuben-Alstead is required by law to keep as records. Cox generally kept Reuben advised as the investigation developed.

57. In the course of his investigation, Cox decided to send out questionnaires to certain of Reuben-Alstead's customers. Ap-

proximately 40 to 50 questionnaires were sent out at Cox' request

by the Securities Division. Cox also interviewed several of the agents at Reuben-Alstead in order to find out the extent of their knowledge about the Norco transactions. Cox advised the agents he interviewed that the NASD could suspend a licensee who failed to answer questions. Cox did raise his voice to one of the securities agents when the agent was uncooperative; however, the agents were free to leave at any time. Reuben was present during the questioning.

58. That any of the foregoing Findings of Fact which should properly be termed Conclusions are hereby adopted as such.

Based upon the foregoing Findings of Fact, the Hearing Examiner makes the following:

CONCLUSIONS

1. That the Securities Division gave proper notice of the hearing in this matter; that the Commissioner of Securities has the authority to revoke or suspend the license of a securities broker or agent or to censure the licensee; that the Securities Division has fulfilled all relevant, substantive and procedural requirements of law or rule.

2. Minn. Stat. 80A.01, provides that:

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly: ... (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

3. Minn. Stat. 80A.07, subd. 1(b)(7), provides that the Commissioner of Securities may suspend or revoke a license or censure the licensee if he:

(7) has engaged in dishonest or fraudulent practices in the securities business.

4. That the Securities Division need not prove specific intent or scienter in proving fraud, deceit, or dishonest or fraudulent practices in its enforcement proceedings.

5. That Minn. Stat. 80A.01 (c) and Minn. Stat. sec. 80A.07, subd. 1(b)(7), require that:

(a) a broker or agent must have an adequate and reasonable basis for recommending a security to a client;

(b) a broker or agent must conduct or rely upon a reasonable investigation of the security in question prior to formulating his recommendation;

(c) a broker or agent must disclose that he lacks essential information about a security if such is the case;

(d) a broker or agent may not recklessly make optimistic statements concerning a stock which have no basis in fact.

6. That Feldman, Mangel, and Zenanko violated Minn. Stat. 80A.01 (c) and Minn. Stat. 80A.07, subd. 1(b)(7) since:

(a) each failed to conduct a reasonable investigation of Norco in that, in the absence of any research by Reuben-Alstead, Feldman's investigation consisted of a review of the 1974 annual report and the earlier newspaper clippings; Mangel reviewed only the 1973 and 1974 annual reports; and Zenanko's investigation consisted of a 20-minute review of the 1974 annual report and some newspaper clippings.

(b) Each failed to advise their clients in April and May of 1975, that they had no information for this speculative stock more recent than Norco's annual report for the year ending September 30, 1974.

(c) Each made optimistic statements concerning Norco which had no basis in fact in that:

1. Feldman told Lloyd Elfrink that Norco could double in price;
2. Feldman told Sherril Stempl that Norco would double in value in about two years;
3. Feldman told Duane Fogel that the North Star gasoline stations would do well in an oil crisis;
4. Zenanko told Nick Moes that Norco would double in eight months to a

year;

5. Mangel told Darwin Sandau that he could double his money in a few months; and
6. Mangel told Curtis Connor that Norco's business was going to turn up due to new management.

7. That Reuben and Reuben-Alstead violated Minn. Stat. 80A.01 (c) and Minn. Stat. 80A.07, subd. 1(b)(7), in that

President Reuben, after being advised and acknowledging on May 28, 1975, that there was a problem at Norco, failed to investigate this information even though Reuben-Alstead was making a market in the stock and proceeded to include Norco on an inventory list to be announced at a sales contest the following day, resulting in the sale of 37,525 shares of Norco on the day before its Board of Directors voted to file for bankruptcy.

8. Minn. Stat. 80A.01, states that:

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:

(b) to make any untrue statement of a material fact or to omit to state material facts necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading;

9. Feldman violated Minn. Stat. sec. 80A.01 (b) in that:

(a) Feldman told Myron Pieri that there was a possibility of a merger between Norco and another company;

(b) Feldman told Larry Pieri that there was a possibility of Norco merging with Grain Belt Breweries;

(c) Feldman failed to tell Elfrink in connection with his statements about the energy crisis that Norco was in default on a trade note with its gasoline supplier;

(d) Feldman failed to tell Fogel, in connection with his statement about the oil crisis, that Norco was in default on a trade note with its gasoline supplier; and

(e) Feldman failed to tell Pfeifer that almost all of the 1974 profit resulted from the non-recurring sale of certain assets.

10. Zenanko violated Minn. Stat. 80A.01 (b) in that:
- (a) Zenanko told Ralph Palmer that Irwin Jacobs had put a large sum of money into Norco;
 - (b) Zenanko failed to tell Palmer that almost all of the 1974 \$.05 per share earnings resulted from the non-recurring sale of assets; and
 - (c) Zenanko failed to tell William Stute that the

upward earnings trend was almost entirely the result of a non-recurring sale of assets.

11. Mangel violated Minn. Stat. 80A.01 (b) in that Mangel told Darwin Sandau that a Japanese firm was going to make a go of Norco's jade business.

12. Minn. Rule S.Div 2125(b)(2) provides:

A broker-dealer may not recommend speculative low-priced securities to customers without knowledge or an attempt to obtain information concerning the customers' other securities holdings, their financial situation and other necessary data.

13. That Minn. Rule S.Div 2125(b)(2), applies to conduct by agents as well as broker-dealers.

14. Mangel violated Minn. Rule S.Div 2125(b)(2), in that he did not ask Charles Hauck or Curtis Connor about their financial situation while recommending Norco and other speculative low-priced stock to them.

15. That the evidence is insufficient to show a violation of Minn. Rule S.Div 2125(b)(2) by Respondent Zenanko.

16. Minn. Stat. 80A.07, subd. 1(b)(10), provides that the Commissioner of Securities may suspend or revoke a license or censure a license if he:

(10) has failed reasonably to supervise his agents if he is a broker-dealer ... ;

17. That reasonable supervision includes maintaining proper compliance procedures, especially where a securities firm is rapidly expanding.

18. That Reuben-Alstead violated Minn. Stat. 80A.07, subd. 1 (b) (10) in that:

(a) The firm's agents were unfamiliar with the compliance manual and did not consult it;

(b) The firm provided no training for its agents;

(c) The firm's compliance officer spent only one-fourth to one-sixth of his time on compliance matters and was retained by the firm despite unsatisfactory performance;

(d) The firm conducted no research of even the most speculative stocks such as Norco and did not require its agents to make any investigation of the stock;

(e) The firm had no effective means of checking the opening of new accounts for suitability; and

(f) The firm failed to effectively monitor the recommendations of its agents to their customers.

19. Minn. Stat. sec. 80A.07, subd. 1(b)(2), provides that the Commissioner of Securities may suspend or revoke the license of a broker or agent or may censure a licensee if he finds that the licensee:

(2) has willfully violated or failed to comply with ... the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, or any rule under any of such statutes,....

20. That a decision on the constitutionality of Minn. Stat. 80A.07, subd. 1(b)(2), is beyond the authority of the Hearing Examiner.

21. Section 5 of the Securities Act of 1933 states:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly - -

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

22. That the stock of Norco Oil Company obtained by Reuben-Alstead from George Kline was not registered pursuant to the Securities Act of 1933.

23. That Reuben-Alstead and Reuben sold the stock of Norco Oil Company obtained from George Kline using the U. S. mails and the telephone.

24. Section 4(3) of the Securities Act of 1933, provides that Section 5 of the Act shall not apply to transactions by a dealer. This exemption is not available, however, to a dealer who is acting as an underwriter.

25. An underwriter is defined by Section 2(11) of the Securities Act of 1933, to be "any person who has purchased from an issuer with a view to, or offers or sells for a issuer in connection with the distribution of any security, or participates in any such underwriting, or participates or has a participation

in the direct or indirect underwriting of any such undertaking...."

26. Section 2(11) of the Securities Act of 1933, defines "issuer" as including "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

27. SEC Rule 405 defines "control" to mean "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

28. That the burden is upon the Respondents Reuben-Alstead and Reuben to prove an exemption from Section 5 of the Securities Act of 1933 in this proceeding.

29. That the Respondents Reuben-Alstead and Reuben have failed to show by a preponderance of the evidence that George Kline was not a control person within the meaning of SEC Rule 405, and that therefore, the Respondents have failed to show that they are entitled to the "dealers exemption" to Section 5 since Kline would come within the definition of "issuer", thereby making Reuben and Reuben-Alstead "underwriters" and therefore not entitled to the "dealers exemption" under Section 4(3).

30. That the Respondents Reuben-Alstead and Reuben failed to qualify for an exemption pursuant to SEC Rule 144 in that the Norco stock obtained from Kline was not sold on an agency basis, and buyers were solicited for the stock.

31. That Respondents Reuben-Alstead and Reuben have failed to prove an exemption for the Kline transaction under Section 3 (2)(11) ("intrastate exemption") of the Securities Act of 1933.

32. That Respondents Reuben-Alstead and Reuben violated Section 5 of the Securities Act of 1933 by purchasing in a principal transaction unregistered, restricted shares of Norco stock from Norco director George Kline, placing the stock in Reuben-Alstead's inventory and then selling the stock to Reuben-Alstead customers on a solicited basis, and therefore, violated Minn. Stat. 80A.07, subd. 1(b)(2).

33. Reuben-Alstead and Alstead violated Minn. Stat. 80A.01(b) and 80A.07, subd. 1(b)(7), in that Alstead signed a letter to Norco's corporate counsel which stated that the shares acquired

from George Kline had been sold in compliance with Rule 144, when in fact the requirements of Rule 144 had not been met.

34. That the Motion of Respondents Reuben-Alstead and Reuben to suppress certain evidence which Respondents alleged was obtained as a result of illegal search and seizures, and in violation of Respondents' right against self-incrimination and right to counsel is hereby denied.

35. Respondent Zenanko and Respondents Reuben-Alstead and Reuben each submitted a set of Motions to Dismiss prior to the hearing in this matter. The Hearing Examiner has necessarily made a recommendation concerning most of these Motions in the course of the preparation of this Report. The balance of the Motions, which were not affected by the development of the evidentiary record in this matter, are referred to the Commissioner for his consideration, since the Hearing Examiner is without authority to dispose of a Motion for Dismissal.

36. The preceding Conclusions are based upon the Findings of Fact, and upon the reasoning set out in the Memorandum attached hereto which is incorporated by reference into these Conclusions.

Based upon the foregoing Conclusions, the Hearing Examiner makes the following:

RECOMMENDATION

It is recommended that disciplinary action be taken against Respondents Reuben-Alstead & Co., Inc., Ben B. Reuben, Harvey A. Feldman and George R. Zenanko.

Dated: August 12, 1977.

GEORGE A. BECK
Hearing Examiner

NOTICE is hereby given that, pursuant to Minn. Stat. sec. 15.0421 (1976), the final decision of the Commissioner of Securities shall not be made until this Report has been made available to the parties to the proceeding for at least ten days, and an opportunity has been afforded to each party adversely affected to file exceptions and present argument to the Commissioner. Exceptions to this Report, if any, shall be filed with the Commissioner of Securities, 500 Metro Square Building, Seventh and Robert Streets, Saint Paul, Minnesota 55101.

MEMORANDUM

It is appropriate to interpret the Minnesota anti-fraud provisions, namely, Minn. Stat. 80A.01(c) and Minn. Stat. 80A.07, subd. 1(b)(7), so as to incorporate the standards or requirements set out in the leading case of *Hanly v. SEC.*, 415 F.2d 589 (2d Cir. 1969). The *Hanly* case interpreted SEC Rule 10b-5, the language of which is almost identical to that contained in Minn. Stat. sec. 80A.01(c). The state and federal regulatory schemes are in many ways parallel and other states have looked to federal case law to interpret their statutory scheme. See *Sauer v. Hays*, 539 P.2d 1343, 1347 (Colo. App. 1975). The *Hanly* case involved the sale by securities agents of a speculative over-the-counter stock which had never shown a profit. The Court stated at 415 F.2d 597:

In summary, the standards by which the actions of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation, he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. If a salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.

A salesman may not rely blindly on the issuer for information concerning a company, although the degree of independent investigation which must be made by a securities dealer will vary in each case. Securities issued by smaller companies of recent origin obviously require more thorough investigation."

The later case of *SEC v. North American Research and Development Corp.*, 424 F.2d 63 (2d Cir. 1970), reaffirmed *Hanley* and noted that, "The 'special relationship' between a broker and the public creates an implied warranty that the broker

has an adequate and reasonable basis in fact for his opinion,
.... 424 F.2d at 84

The investigation of Norco which was conducted by Respondents prior to their recommendation of the stock in the Spring of 1975 cannot be called reasonable. The Respondents essentially reviewed only the 1974 Annual Report for the fiscal year ending September 30, 1974. The facts contained in the

1974 Annual Report alone should have put the Respondents on notice that Norco was in a precarious financial position, and was therefore a risky investment which required a continuing investigation.

What constitutes a reasonable investigation will vary depending upon the type of company whose securities are being sold. Information on larger established companies is usually readily available through reporting services such as Standard & Poor's or Moody's. None of the reporting services publish data on small, local, speculative companies, like Norco. Securities firms with research departments are obviously able to compile current data upon which a salesman may rely. In the case of Reuben-Alstead and Norco, however, the firm conducted no research of the stock. Reuben-Alstead had no research department. Either the firm or its agents could have contracted for research services, however. The Respondents could have requested that Norco send them a copy of its SEC filings at the same time that they are mailed to the SEC. The Respondents could also have requested copies of the filings from the SEC. These filings would have given the Respondents much more current information concerning Norco. The February 18, 1975 filing showed a loss for the last three months of 1974 substantially in excess of that of the last quarter of 1973. The May 15, 1975 filing showed a net loss of \$92,140 for the six months ending March 31, 1975. The May 13, 1975 filing would have alerted the Respondents to the fact that Norco had lost its supply of gasoline and was considering bankruptcy. Apparently, none of the Respondents attempted to obtain the minutes of shareholder or directors' meetings, nor did they attempt to contact anyone in Norco's management or its board of directors to obtain information concerning the company.

The factors disclosed in the 1974 Annual Report included the fact that the accountant who audited Norco's financial statements declined to render an opinion because, due to the precarious financial position of the company, he was unable to assume that it was a "going concern." This is a very unusual occurrence and

should be a "red flag" to the reader of the Report. The President's letter disclosed problems with the oil and gas operations, and indicated that future profits could not be predicted in regard to the retail gasoline operations. All except approximately \$10,000 of the net earnings resulted from the non-recurring sale of an asset, namely, certain North Dakota oil properties. The report revealed that in July of 1974, Norco's bank had demanded payment in full of an indebtedness of \$370,000. The total assets were listed at \$1,363,138, of which over half was attributable to jade claims and capitalized jade production costs. Total current liabilities exceeded total current assets by over \$400,000. Since the Respondents failed to make a reasonable investigation, they could not have had a reasonable basis for recommending Norco's stock in the spring of 1975. However, the negative factors contained in the 1974 Annual Report do not, in any event, permit a reasonable basis for recommending the stock.

The Hanly court recognized that a special duty is imposed upon those who sell speculative, unseasoned over-the-counter stocks. The SEC has long maintained, as was set out in Reuben-Alstead's compliance manual, there is a substantial risk of violating antifraud provisions by recommending speculative low-priced securities. If reliable information concerning an unregistered security is not readily available, the agent must either take adequate steps to obtain such information or forego recommending the stock to his customers, since he does not have an adequate basis to do so.

The Respondents also failed to tell their customers in May of 1975 that, in effect, they had no idea what had happened to Norco since September 30, 1974, at which time it was in a very precarious financial position.

Given Norco's background, the optimistic statements made by the Respondents, which had no basis in fact, were reckless. There was no reason to believe that Norco would double nor that it would do well in the future. In the context of Norco's problems,

such statements become completely misleading to investors, especially those who are relatively unsophisticated concerning the stock market. The Hanley court stated that:

Brokers and salesmen are "under a duty to investigate, and their violation of that duty brings them within the term 'willful' in the Exchange Act." Thus, a salesman cannot deliberately ignore that which he has a duty to know and recklessly state facts about matters of which he is ignorant. He must analyze sales literature and must not blindly accept recommendations therein. 415 F.2d at 596

The Respondents have contended that specific intent or scienter is a necessary element of proof in this proceeding in regard to fraud. The Hanley case explicitly held (415 F.2d at 596) that specific intent to defraud is irrelevant in SEC enforcement proceedings. The Respondents urge that the recent case of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), changes the law. It appears, however, that the Ernst case states that scienter may be necessary in a private action for money damages. The case involved a suit against accountants who allegedly negligently audited the company whose securities were sold. Even prior to the Ernst decision, there has been a difference in the law in regard to the necessity of proving scienter as between private actions for money damages and enforcement proceedings. The rule has been that specific intent need not be proved in enforcement actions. See 2 A. Bromberg, Securities Law: Fraud Sec. 8.4 p. 585 [at n. 6-7] (1975)

Reuben and Reuben-Alstead also violated the anti-fraud provisions through Reuben's negligent conduct at the end of May of 1975 concerning Norco. Reuben was aware that Norco was a risky investment in the spring of 1975, and he was also aware that neither he nor his firm had done any research or investigation concerning the company. On May 28, 1975, he was specifically informed that there might be a problem at Norco, and yet he proceeded to purchase 25,000 shares of Norco from George Kline that evening and to include Norco in a sales contest the following day. The fact that Reuben asked Silverman to sell a large block of Norco and the fact

that Reuben paid Kline only ten cents per share in fulfilling his promise to purchase all of Kline's 35,000 shares, indicates that Reuben believed what Silverman told him. Despite this, Reuben failed to even attempt to investigate Norco's situation and failed to advise Reuben-Alstead's agents that Norco had become an even riskier investment.

The Respondents have urged that Minn. Rule SDiv 2125(b)(2) should be applied only to broker-dealers since it fails to mention securities agents. The rule must necessarily be read to include securities agents if the rule is to make sense. The rule would be largely unenforceable if it could not be applied to securities agents and such an absurd result should not be presumed, especially where it would apparently contravene the intent of the legislation. Similar federal and industry rules apply to agents.

Perhaps the clearest pattern that emerges from the record in this matter is the failure of President Reuben and Reuben-Alstead to reasonably supervise the securities agents employed with the firm. It appears that as the firm underwent rapid growth from 1973 to 1975, very little time or manpower was devoted to matters of compliance. The firm's compliance officer spent a small amount of his time on such matters and was largely ineffective in the performance of his duties at any rate. The firm had developed no effective means of checking the propriety of its agents' sales techniques. The agents, themselves, testified that the firm provided no training, held compliance meetings haphazardly, and failed to acquaint the agents with its compliance manual. The firm provided no support to its agents by means of research, either in-house or by contract and failed to update its training files beyond the receipt of annual reports. The failure to effectively supervise the agents and to conduct an adequate compliance effort is evident from a review of the violations of law by securities agents contained in this report. The chief operating officer of a corporate broker-dealer must necessarily be responsible for supervision of the securities agents, and, in fact, President Reuben acknowledged that he is ultimately responsible

for the activities of Reuben-Alstead. It appears that the language of Minn. Stat. sec. 80A.07, subd. 1(b) (10) , precludes action against an agent's license for failure to supervise, however. Presumably the assumption is that a poor supervisor may still retain his agent's license unless he is actually charged with wrongdoing under another provision of Chapter 80A. See In the Matter of Ray C. Cordell, Commissioner of Securities, Wisconsin, July 31, 1972 (CCH Blue Sky Law Reporter, paragraph 71, 210)

Respondents Reuben and Reuben-Alstead have argued that any attempt by the Securities Division or the Commissioner of Securities to enforce provisions of the Federal Securities Act of 1933 pursuant to Minn. Stat. 80A.07, subd. 1(b)(2) cannot be sustained. The Respondents apparently suggest that the statute cited is unconstitutional in that the federal enforcement scheme preempts state enforcement and that there is no valid state interest in enforcing the federal securities laws. The Hearing Examiner concludes that such a challenge would have to be decided by the courts and that the Hearing Examiner is without authority to determine the validity or constitutionality of a state statute.

It is concluded that Respondents Reuben and Reuben-Alstead violated 5 of the Securities Act of 1933 in their handling of the Kline transaction. The Respondents urge a restrictive interpretation of the word "sell" in 5 and suggest that Reuben was not actually the agent who executed the sales to customers of Reuben-Alstead. Such a definition is unreasonably narrow and fails to effectuate the purposes of the Act. Reuben bought the 35,000 shares from Kline for placement in Reuben-Alstead's inventory for use in connection with its market-making activities. There is no doubt that a sale to members of the public was intended by Reuben. Reuben also approved including Kline's shares, the last 25,000 of which were purchased on May 28th, in a sales contest held on May 29th. Reuben, in his capacity as president, also reviewed the order tickets resulting from the May 29th sales of Norco stock. Reuben therefore contracted to sell or dispose of the Norco stock for Kline within the meaning of 5. The transfer of 10,000 shares of Norco, which originally came from

George Kline, from Kevco, Reuben-Alstead's street name, to six customers of Reuben-Alstead, proves delivery of the stock and is sufficient to support the conclusion that a sale occurred.

Respondents have suggested that the burden of proof should not be upon them to prove an exemption from 5 in this state enforcement proceeding. It appears that the federal law puts the burden on the person claiming an exemption, and it further appears that Minn. Stat. 80A.15, subd. 4, places the burden of proving an exemption or exception in the state regulatory scheme upon the person claiming it also.

The major dispute in regard to the sale of the Kline stock is whether the transaction was exempt under 4(3) of the 1933 Act, the "dealers exemption". The argument revolves around whether or not Kline was a control person such that he comes within the definition of issuer which would then preclude Reuben and Reuben-Alstead from claiming the dealers' exemption. Although there is authority for the proposition that a director is per se a control person (see SEC v. Computronic Industries Corp., 294 F. Supp. 1136, 1139; (N.D. Tex. 1968)), additional facts exist in this case which would justify George Kline being considered a control person. The Norco board of directors was a small and friendly group of businessmen. Kline was an active director as compared to other members of the board, and was friendly with Irwin Jacobs, the board's most influential member. Kline himself testified that the board would have allowed him to have Norco stock registered if he had paid the expenses in connection therewith.

The Respondents have failed to show that they are entitled to an exemption pursuant to sec. 3(a)(11) of the Act since they have failed to show that Norco shares were not sold to non-residents of Minnesota and since the evidence does not support the conclusion that Norco came within the safe harbor of Rule 147.

The Respondents have suggested that Reuben-Alstead and Alstead cannot be found in violation of the anti-fraud provisions due to execution of the letter from Alstead to Norco's corporate counsel stating that the shares acquired from George Kline had

been sold in compliance with Rule 144, since the statement by Alstead was not prior to or contemporaneous with the sale of stock, was not made to a purchaser or seller, and in any event, was not a material statement. The language of Minn. Stat. sec. 80A.01(c), namely, "in connection with the offer, sale or purchase of any security" is broad enough to encompass the activity which occurred herein. While Alstead's statements were not made to a purchaser or seller of the Norco stock, this misrepresentation was more serious since without it there would have been no improper sales to customers of Reuben-Alstead. The statements made in the letter were certainly material in that they were the factor which caused Norco counsel to recommend removal of the restrictive legends on the Kline stock.

By motion supported by Memorandum made prior to the hearing in this matter, the Respondents raised the question of whether or not certain evidence should be suppressed by reason of being unconstitutionally obtained. Since the record in this matter fails to support the allegations of a violation of due process or constitutional rights in the course of the investigation of this matter by the NASD and Securities Division, the motions to suppress have accordingly been denied. The record supports the fact that the documents obtained from Reuben-Alstead were voluntarily provided by President Reuben and that his consent was freely given and was not the result of intimidation of any sort. The records requested by the NASD investigator were documents which the Respondents were required to keep by reason of NASD rules and Minnesota Statutes. Even had consent not been freely given in this matter, there is authority for the proposition that there is an implied consent to such inspection in licensed and heavily regulated businesses such as the securities industry. See *Almedia-Sanchez v. U.S.*, 413 U.S. 266 (1973).

The Respondents also raised arguments concerning a violation of the Fifth Amendment right prohibiting self-incrimination and the Sixth Amendment right to counsel in the course of the investigation of this matter by the NASD. Although the record does support a conclusion that an NASD investigator became angry in the course of the questioning of one of Reuben-Alstead's agents,

the evidence does not support the conclusion that the statements were obtained through the use of threats or intimidation. There is, at any rate, no evidence that the interviews conducted with the securities agents were custodial, which is a prerequisite to requiring a warning pursuant to *Miranda v. Arizona*, 284 U.S. 436 (1966). There is authority for the proposition that Respondents do not have a right to counsel during the administrative investigation. *U.S. v. Steele*, 238 F.Supp. 575 (S.D. N.Y. 1965). No conduct herein would suggest the need for any change in that holding.

G.A.B.